DOW THEORY LETTERS INC.

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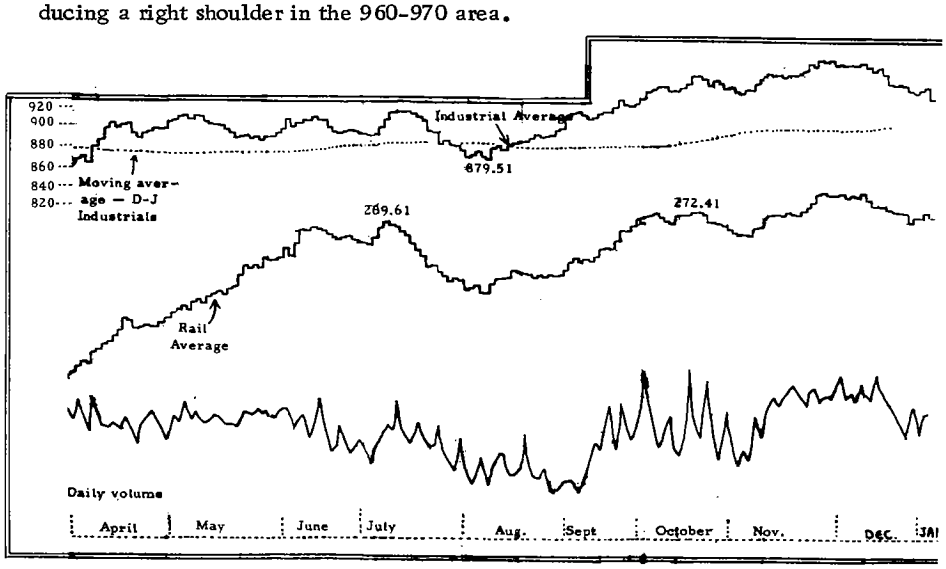
THE MARKET: The market ended 1968 with a downside whimper. Having risen the final two days of the year 12 out of the last fifteen years, it sank on the two last days of 1968. In fact from the year's high of 985.21 struck on December 3, 1968, the Dow dropped some 41 points in December, reaching a December low on the last trading day of 1968.

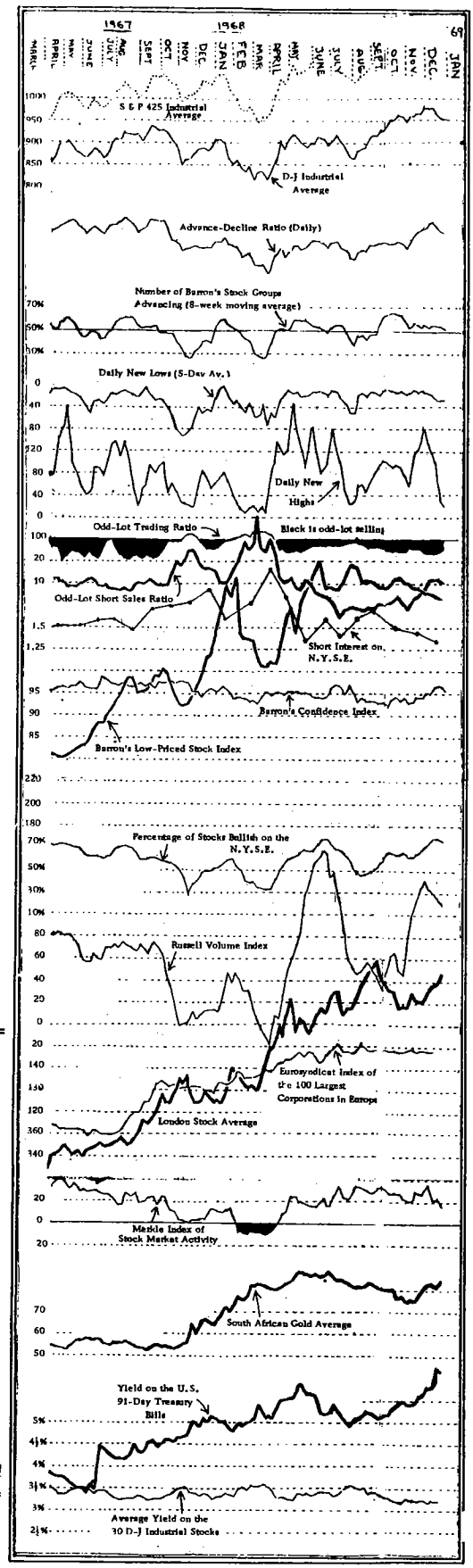
Some say that when the market does not show strength at a time when seasonally it is most apt to show strength, it is a sign of weakness. Maybe and maybe not; yet my feeling is that although it was a poor December performance, the weakness could have stemmed from mere uncertainty regarding the outlook for what could be an extraordinary 1969.

January is normally chock full of Christmas bonus buying, year-end dividend reinvestment buying, extra dividend buying and reinvestment of funds from gains and losses taken the previous year. This type of "extra" strength ordinarily can be expected to exert a positive influence on the market to around January 15. After that, Wall Street is "on its own."

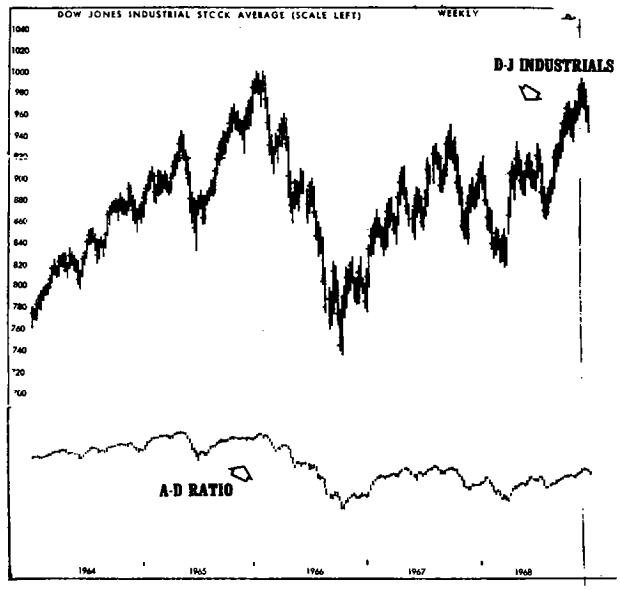
The technical position of the market as the new year begins is rather nebulous. Odd lotters proved surprising by pulling in their heavy selling during the final weeks of 1968, when normally those weeks are characterized by heavy selling. Thus, the odd lot figures are now considerably less bullish than has recently been the case. The total market short interest is on the bullish side, but the Dow short interest (see later section) is decidedly bearish. Selling pressure is coming into this market, and this is seen in the phenomenon of the 10-day average of daily declines currently being well above the 10-day average of daily advances. Volume indications due to the new short trading days are now somewhat confused, and it will take a week or so before analysts can draw any conclusions from daily volume of transactions.

Of interest to me is the potential "head-and-shoulder" pattern in the Industrial Average (see chart) with the left shoulder at October's 967.49 peak, the head at the 1968 high of 985.21 (December) and the possibility of a rally here producing a right shoulder in the 960-970 area.




1967
1968
69
S E P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Sales Ratio
Short Interest on N.Y.S.E.
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of Stocks Bullish on the N.Y.S.E.
Russell Volume Index
Eurosyndicat Index of the 100 Largest Corporations in Europe
London Stock Average
Merkle Index of Stock Market Activity
South African Gold Average
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

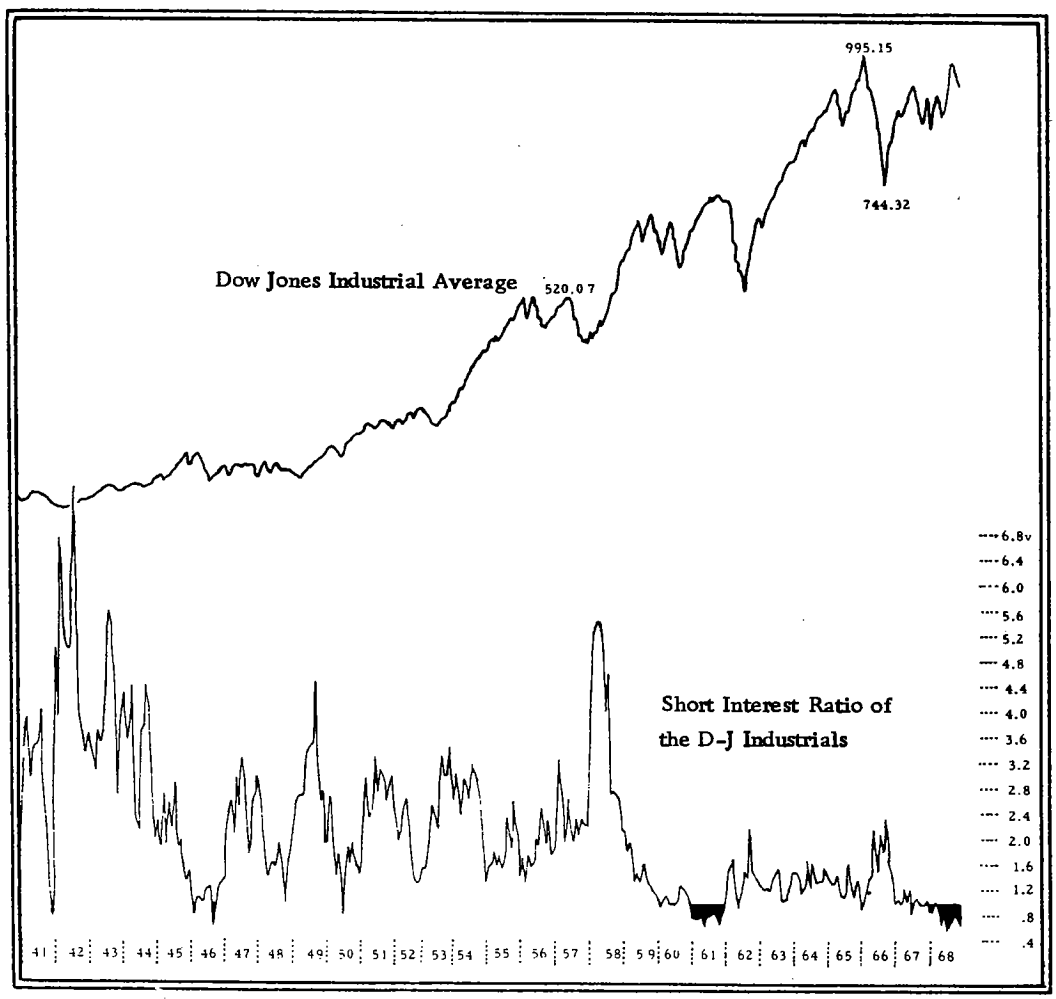
I would watch for a listless advance from here into mid or late January, and then a downturn. Such action could be the formula for trouble, particularly if volume tends to expand with lower prices. I always feel uncomfortable when attempting to outguess the market over the short-term, but I would think that by the end of January the trend of the market for the first quarter will be established.



ADVANCE-DECLINE RATIO: Although only Joseph Granville seems to have noticed it, the advance-decline ratio has now produced a long-term non-confirmation, a non-confirmation which will not be erased unless the ratio can better its August, 1967 high.

Note on the accompanying chart (chart courtesy of Traders Research) that although the Dow Industrials bettered their 1967 peak by rising to 985.21 on December 3, 1968, the advance-decline ratio failed by a slight fraction to confirm. I feel that this is a significant non-confirmation and it may well be a long-term technical danger signal. Such non-confirmation in the past has frequently been associated with one or more "tries" for the old high before important trouble sets in. For that reason, it would not surprise me to see this market rally a few times in an attempt to "remove" the technical non-confirmation between the Dow and the A-D ratio. My guess, however, is that the breadth of this market is too tired to allow for a confirmation of the A-D ratio above the 1967 high.

OMINOUS INDICATOR: In Letter 401 and again in Letter 405 I discussed in detail an important indicator developed by Bill Gordon of Indicator Digest, the short interest ratio for the 30 Dow Industrial Stocks. A careful study of this indicator suggests that it has been a good deal more accurate than the widely-followed short interest ratio of all stocks on the N.Y.S.E.



I include a chart of the Dow short interest which covers the period from 1941 to the present. Note that on the chart there have only been four periods (black areas on chart) in which the Dow short interest (DSI) has fallen below 1.0. The first (lasting only one month) occurred at the end of 1941, preceding the final slide into June, 1942. The second period which included March, May and June 1946, preceded the crash at the end of 1946.

More important from the DSI standpoint was the broad area of 1961 in which the DSI was below 1.0 during every single month of that year. The DSI figures for 1961 were Jan. .73, Feb. .68, Mar. .73, Apr. .74, May .80, June .64, July .78,

Aug. .80, Sept. .86, Oct. .76, Nov. .62, Dec. .77. This dangerous record during 1961 was followed by the crash of 1962 in the stock market.

Coming to the present, it is worth noting that the second broad danger area on the DSI since 1941 has now appeared. Except for the March, 1968 figure, every month during 1968 has produced a tabulation below 1.0 on the DSI during 1968. The 1968 statistics on the DSI are as follows: Jan. .85, Feb. .85, Mar. 1.13, Apr. .84, May .64, June .87, July .53, Aug. .85, Sept. .75, Oct. .79, Nov. .70.

Under the DSI study the market is now on extremely dangerous footing, and the situation from the DSI standpoint can only be compared to the year 1961. I feel that the DSI study is particularly important because it received (happily) such a small following. I am indebted to Bill Gordon of Indicator Digest for the monthly tabulations of the DSI, and except for an occasional chart of the DSI in Indicator Digest, this important study appears in no other service but Dow Theory Letters.

MONEY: Pity poor Mr. Nixon. Here we are starting off the New Year with interest rates near their highest level in history, an economic boom which "refuses" to cool off, gold near the $42 level, a Republican President with a team described by Eliot Janeway as "....an assortment of hacks, lame ducks and amateurs without power bases," and a Democratically controlled Congress (the second time in 120 years that the U.S. has had a President and a Congress on the opposite side of the political fence).

To put it mildly, it presents an interesting picture. From all quarters come reports that the first item on the 1969 agenda will be an international monetary conference, a conference which will try to make sense out of the shambles which is now the international monetary scene.

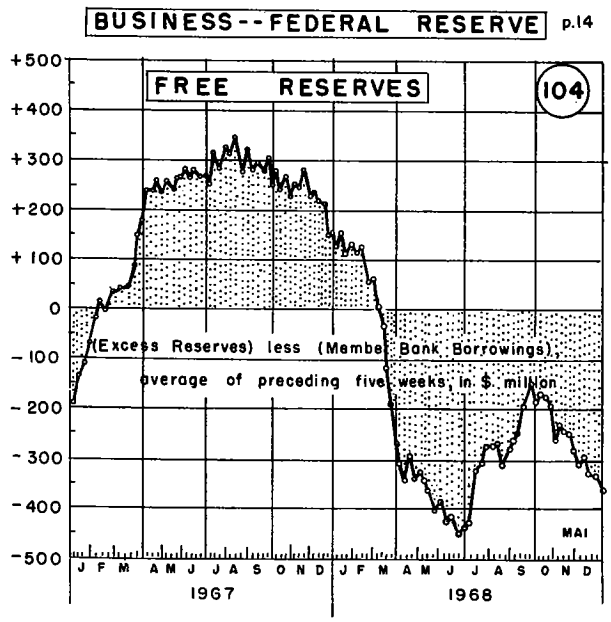
But already, the monkeywrenches are being thrust into the conference idea, as note from this little clip regarding the German attitude towards a monetary conference. Without Germany there can be no conference, so from this standpoint it is simply a matter of whether the Germans are jockeying for power or whether they are serious about avoiding a conference.

Germans Cool Toward Talks

FRANKFURT, West Germany (AP) — West German Economics Minister Karl Schiller and Central Bank President Karl Blessin yesterday rejected an international monetary conference in 1969 because, they said, it would touch off a wave of speculation.

Speaking on a West German television program on the economic outlook for 1969, they said they both felt that the pending monetary problems should be discussed by the nations involved in bilateral talks.

Meanwhile, the "fine tuning" about which our economic experts have been boasting for so long is in for its ultimate test. As seen on this chart (courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y.), the Federal Reserve is fine tuning all over the place. The chart is based on a five-week average of excess reserves minus member bank borrowings, and here we see the massive drop in free reserves which began in mid-1967. The drop turned to minus reserves in mid-1968. Then as the pressure for funds grew more intense, the Fed eased reserves through to October, 1968.



But with inflationary pressures literally going through the roof, the Fed reversed its course, and over the past quarter it has been minus reserves again. The result of minus reserves plus an extraordinary mass of borrowing from all sources has pushed interest rates to their highest levels in 100 years.

Nevertheless, inflation continues, and it will be up to the Fed and the new Administration to "dis-inflate." So far, interest rates alone have not slowed the booming inflation, and it seems to be a case of money for expansion at any price, regardless of the rate of interest.

Actually, there has been plenty of cash around, and the single obstacle to the borrower has been the fantastic level of interest rates. But one wonders what will happen if, in desperation, the Fed continues to cut back on the money supply. With interest rates at their current 100-year high, an important cut-back in the money supply would produce "panic rates" of interest. If I had to guess at the panic rate,

 I would guess 7% on the 91-day Treasury bills and about 6.8 to 7% on the bellwether 4¼ Treasury bond of 1987-92.

The Nixon team despite forthcoming grandiose spending plans (particularly in the defense area) seems to be committed to something called "a balanced budget," together with brakes on inflation. It should be interesting to see how they are going to do this— short of a collapse in the stock market. In case readers are wondering, I don't know the answer myself.

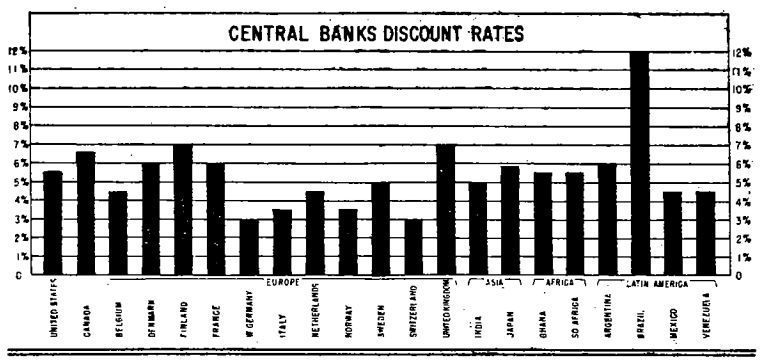
CRYSTAL BALL 1969: People have a tendency to believe that the immediate past is the key to the future. For instance, if the immediate past has been happy, forecasters will usually take the position that the immediate future will be happy. Going on this premise, I was interested to see the latest U.S. News and World Report international forecast for 1969. Following are some excerpts, and they seem fairly typical of forecasts everywhere.

The U.S. "All in all, 1969 looks like a solid if not spectacular year for business."
"Continental Europe will be in the second year of an economic upswing that is expected to last into 1970."
"Britain, despite official 'austerity,' is on a consumer-buying binge."
"No end in sight for the surge in Canada. Growth may hit 8%."
"Frankfurt: everybody is optimistic in Germany."
"Paris— on paper, things look pretty good in France."
"Dutch are forecasting rosy times through 1971."
"Belgium and Austria are happy."
"Australia's minerals promise more boom there. U.S. sales are to be pushed."
"Swiss figure their orders from abroad may top 1968 by one eighth."
"Tokyo— Business is expected to jump 11%. New business investment 15%."

So you name it, the crystal ball, according to U.S. News and a majority of other forecasters is for boom and more boom in 1969. Those who have historical familiarity with Dow's Theory, however, cannot but feel a little apprehensive about the picture. Dow Theorists know that markets have a habit of topping out when all the predictions are rosy and when nary a cloud dots the horizon. Seldom has there been a time when the market and the economies of the world were so caught up in economic and financial frenzy. Seldom have so many potential danger signals been ignored.

The world has lived with high interest rates and monetary dislocations for a number of years now, and so far every squeeze and crunch has been surmounted. The U.S. loss of gold has been weathered as has the British pound devaluation, record interest rates in the U.S., mounting debts throughout the Free World.

Perhaps the best barometer of the times is this chart of Central Bank discount rates. Of 21 leading bank rates, only 2 are below 4.5%, while 13 are at 5% or better. This suggests a money battle on a wide front, and my guess is that the battle is going to climax in 1969. High interest rates are designed to protect or to siphon off and hold money. Not everyone can win at this game. Sooner or later, the weak links will give way, and then the trouble starts.

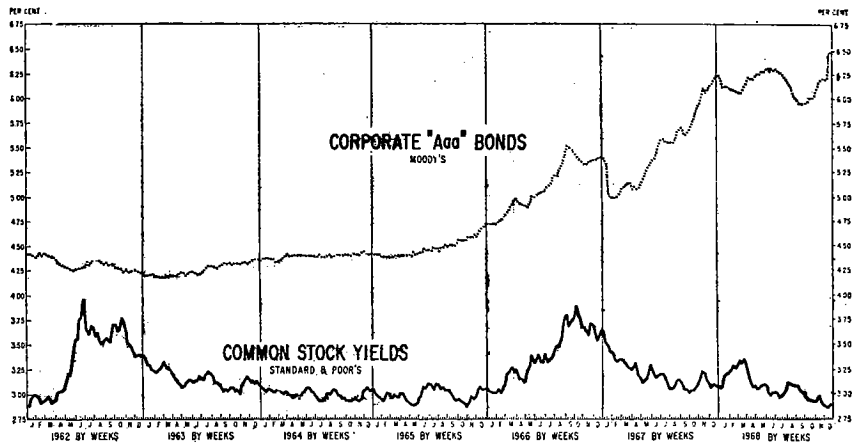


CLARIFICATION: I received a letter a few weeks ago from Douglas Johnston, following his Dec. 6 speech before the Northwest Mining Assoc. Convention. Mr. Johnston, a reader of these reports, notes that I have not made clear to my readers why inflation is now in its final throes.

Quoting from Mr. Johnston's speech is edifying: "The Federal Reserve has kept our inflationary boom going primarily through our gold losses— nothing else. We stopped selling gold in March, 1968, so the inflation is over. That's it. That's the secret of the Great Society. This explains why our Government has been staging its giant 'PR' campaign against gold, they had to sell gold to keep the boom going!

"Let me explain. When the U.S. loses gold, as it did last March to the tune of over $2 billion worth, these two billion paper dollars get into the hands of the Federal Reserve. If the Fed does nothing with this money, nothing happens. But, if the Fed uses this money to buy Treasuries from the commercial banks, all hell breaks loose. This creates bank credit on a fantastic scale. This creates high-powered credit on a ratio of about 7 to 1."

RECORD: Just to keep the historical record straight, a week ago the negative yield spread between stocks and bonds widened to an all-time record. The Standard & Poor 500 Stock Average held at 2.91% while Moody's Aaa-rated Bond Average dropped in price to provide a yield of 6.48%. The adverse yield spread in favor of bonds thus rose to 3.57%, a record in Wall Street annals.



The yield on the S & P 500 has now held below the 3% level for 14 consecutive weeks. Historically, the average time span below 3% has been six weeks—prior to serious trouble. So—one might say we are overdue for "a yield correction."

Here's another one for the record: last week for the first time in modern history the yield on the D-J 40-Bond Average hit 7%. Remember the excitement in the bond market when the old "Magic Fives" came out. Those were the days.....

NOTES & QUOTES: From the London Spectator (December): "America has made a habit of solving its social problems by ignoring them. That is, it has overcome social conflicts and met new demands through the ability of its economy to stretch itself as required without tearing under the strain. When the economy fails, as in the Thirties, all bets on American stability are off. The economy which President Nixon is faced with administering is stretched taut today. And both internationally and domestically, it has begun to tear."

From the January Forbes interview with Jerry Castle, president of Penn-Dixie: "I'm opposed to conglomerates because history is not on their side. The big successes in mergers have been Standard Oil of New Jersey, U.S. Steel, General Motors—companies that were integrated but not conglomerates. The only company that can't miss as a conglomerate is one where the pieces were all strong before they merged. I'm especially critical of the fellow doing $250 million a year when he has 32 companies each doing $8 million."

LATE NOTES: As this is written the Dow is down 13 points (Monday morning, January 6). This is in sharp contrast to the expected early January "reinvestment demand," and it follows the very atypical and disappointing December performance. If the Dow closes around 740 or below, the "head and shoulders" pattern discussed on page 1 will have been completed. Then we will see whether this particular "top" pattern has any force in it or not. I have the feeling that most people expect any forthcoming downside action to terminate well above 900 on the Dow.

I want to remind readers of the annual high-low bar chart which was included in Letter 414. With all Dow action now included in the new or 1969 bar on this chart, it is well to note that anything under 950 breaks below the lower trendline of the great 1942 to 1966 channel. I consider such a penetration to be long-term bearish.

HA...I've never before included a cartoon in Dow Theory Letters, but I liked this British humor and here it is. Maybe this is a good way to start 1969. I hope we can all still enjoy a little laugh by the time 1969 is over.